CAPITOL
INVESTMENT ADVISORS
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Strategic Report

Idaho State Treasurer Diversified Bond Fund

For the Period Ending September 30, 2009

Total Return Commentary

The U.S. Treasury yield curve "flattened" slightly during the third quarter of 2009, with rates moving slightly lower across the maturity spectrum. Interest rates for 3-Month Treasuries, 2-Year Treasuries and 10-Year Treasuries were down 7, 16 and 23 basis points, respectively. Despite the flattening of the yield curve this past quarter, the yield curve has still experienced a "steepening" of rates over the past 12 months. The difference in yield between 30-Year Treasuries and 2-Year Treasuries increased the past twelve months from 235 basis points to 311 basis points.

The decrease in rates across the curve resulted in a positive movement in principal value for U.S. Treasuries, with the Intermediate U.S. Treasury Index up 1.7% for the quarter. This, however, was dwarfed by the roaring credit, ABS (asset-backed) and CMBS (commercial mortgage-backed) sectors. U.S. Intermediate Corporate bonds were up 6.1%, asset-backed securities were up 6.3% and the commercial mortgage-backed sector was up an incredible 12.7%. This follows a quarter when the Commercial Mortgage-Backed Index was up 12.5%. The Barclay's Capital Intermediate Aggregate A+ Index (the portfolio's market benchmark) posted a positive return of 2.9% with a year-to-date total return of 4.9%

During the first quarter, the Diversified Bond Fund was up 2.6% with a year-to-date total return of 5.8% (excluding sweep cash). The underperformance for the quarter as compared to the index was due to a conservative maturity/duration stance and an underweight in the commercial mortgage-backed and credit sectors. Since inception in June of 2000, the DBF (including cash) has returned 65.3% which corresponds to a 5.7% annualized return. The current yield to maturity for the Diversified Bond Fund is 2.8%. The effective weighted average duration for the portfolio is just 2.4 years. The duration of the comparable index is 3.2 years. The weighted average duration of the portfolio has been decreased in anticipation that longer-term rates will trend higher from current levels.

Portfolio-Specific Issues

Total return in a fixed-income portfolio is made up of income and principal fluctuations due to changes in interest rates. In a rising interest rate environment, the principal value of fixed-income securities can decrease. If participants invest principal for a time period shorter than the portfolio duration they could face a situation where they could lose money on a total return basis. Accordingly, participants are encouraged to place only assets that are expected to be invested over a 3.5 year or longer period in The Idaho State

Treasurer's Diversified Bond Fund. In addition, participants are encouraged to reinvest as much of the income as possible to fully participate in the benefits of the Diversified Bond Fund and its focus on total return.

Market and Portfolio Commentary

The fixed income markets continued to be quite volatile during the third quarter. There were major rallies in some sectors as the pace of severe negative economic news continued to slow. The credit markets reacted quite well to the trend of lessening negative news. The Commercial Mortgage-backed market's significant positive return is likely due to a return to levels closer to equilibrium and fairer pricing following the panic caused by the events beginning last September.

Although the financial crisis appears to be over the economic crisis does not appear to be over. We have significant concerns regarding the economic and fixed income environment in the short to intermediate-term. Large federal and trade deficits, a potentially weakening dollar, as well as under-supply/increasing demand issues for commodities including energy and raw materials could result in higher inflation and rapidly rising interest rates at some point in the U.S.

We will continue to maintain a duration less than the benchmark. We will overweight the mortgage sector, and look to overweight the U.S. government agency sector as we feel these provide the best current relative value.